ASSET MANAGEMENT AND INVESTMENT FUNDS

Central Bank Publishes CP86 Review Findings

20 October 2020

The Central Bank has published the much anticipated findings of the review of its Fund Management Company Guidance (commonly referred to as "**CP86**").

The Central Bank communicated its findings ("**Findings**") in an industry letter that all fund management companies (including self-managed investment funds) ("**FMCs**") should use to "critically assess" their operating models and resourcing and governance arrangements. In addition, the Central Bank is issuing a number of risk mitigation programmes to certain FMCs. However, the Central Bank expects all FMCs to review the issues identified in the Findings and to develop and progress individual action plans to address these issues and meet the Central Bank's expectations. These actions plans must be approved by the board of directors of the FMC by the end of Q1 2021. The most significant findings relate to substance and governance. The Central Bank has stated that all FMCs should have a minimum of 3 FTEs (full-time employee or equivalent to full time employee) and should appoint locally based Designated Persons ("**DPs**") and other staff who have sufficient time to dedicate to their roles and responsibilities, including delegate oversight. FMCs will have to carefully consider their resourcing requirements and decisions and ensure that they conduct appropriate due diligence on delegates and PCF-holders.

Background

The Central Bank conducted its CP86 review in three phases. On 21 June 2019, the Central Bank launched the first phase of the review with the issuance of a Fund Management Company Guidance questionnaire ("**Questionnaire**") to the Chairs of all FMCs. The Central Bank's analysis of the responses to the Questionnaire was followed up with phase 2 of the review which consisted of desk-based reviews which focused on organisational effectiveness; and the delegation of and performance of the fund risk management and investment management functions. The onsite inspections which formed phase 3 of the review involved meetings with the DPs for fund risk management and investment management; the organisational effectiveness director ("**OE Director**"); and support personnel from these areas as necessary.

In its Findings, the Central Bank notes that some FMCs demonstrated that they were broadly compliant with the CP86 framework. These FMCs have resourcing and operational structures in place that support a considered and well-planned approach to implementation of the CP86 framework. Many of these FMCs were authorised following the introduction of the CP86 rules in 2017. The Central Bank found that, in their view, many FMCs authorised prior to the introduction of CP86 have failed to fully implement CP86 and could only evidence the introduction of very limited changes as a result of CP86. The key issues identified by the Central Bank and its expectations for FMCs are set out below:

Resourcing

Identified Issues: According to the Central Bank, a number of FMCs authorised prior to CP86 taking effect did not have appropriate levels of resources in place to ensure the effective implementation of the framework. The Central Bank's review highlighted material divergences between the resourcing standards in FMCs authorised pre and post the introduction of the CP86 framework. The Central Bank also noted an absence of formally documented succession plans.

The Central Bank also found that employing less resources was often indicative of an over-reliance on group entities and/or delegates.

The Central Bank also noted the co-mingling of support staff within both the investment management and risk management functions.

Expectations: The Central Bank expects all FMCs to:

- clearly demonstrate ongoing and effective management of their activities, including effective oversight of the activities performed by delegates and to be able to demonstrate that its governance structure, including its entity-specific second line of defence (i.e. the compliance and risk functions), is adequately resourced to achieve this;
- have a minimum of 3 FTEs, each of whom is suitably qualified and of appropriate seniority to fulfil the role.

  This number is only relevant for the smallest and simplest of entities. Other firms will be expected to have a number of FTEs as determined by the nature, scale and complexity of their operations. No additional guidance has been provided as to how a small, non-complex entity should be understood, nor is it clear how this applies to a self-managed investment fund;
- appoint locally based DPs and other staff who have sufficient time to dedicate to their roles and responsibilities, including delegate oversight. In larger FMCs, DPs are expected to be full-time roles. Further clarity from the Central Bank is required as to whether this requirement extends to all DPs and, if so, how this can be reconciled with the Central Bank's "location rule" which provides that at least three of the managerial functions should be performed by two DPs who are EEA-resident; and
- keep their resourcing levels under review, particularly as their operations grow in scale and complexity.

Designated Persons

Identified Issues: The Central Bank identified significant shortcomings in the performance of the DP role including:

- inadequate challenge of delegates;
- poor quality of reporting from the DP to the board;
- insufficient review of monthly reports from delegates and varying degrees in the level of independent analysis of the information provided by delegates; and
- DP time commitments falling below the Central Bank's expectations.

Expectations: The Central Bank expects that DPs should have enough time available to conduct their roles thoroughly and to a high standard and should be able to clearly evidence the value they bring to that oversight through documented board reporting.

Delegate Oversight

Identified Issues: The Central Bank identified a number of weaknesses with regard to delegate oversight. These included:

- FMCs being unable to demonstrate that the appropriate level of due diligence had been conducted on delegates both at the initial appointment stage and on an ongoing basis;
- FMCs being unable to evidence that where they relied on group/delegates' policies and procedures that these policies and procedures had been reviewed and approved as being appropriate for the FMC;
- FMCs not formally documenting service level agreements ("**SLAs**") in respect of all delegated activities which leads to the risk that those activities are not (i) governed in an appropriate manner; or (ii) compliant with legal/regulatory requirements; and
- a lack of effective engagement with delegated investment managers, including issues arising not being resolved in a timely manner and the receipt of poor quality delegate reports which do not allow for a meaningful review of a situation.

Expectations: The Central Bank expects:

- due diligence reviews of delegates to be conducted at take-on and on an annual basis thereafter;
- that where reliance is placed on delegates' policies and procedures that there is a formalised review process to review and approve them both on appointment and on an ongoing basis;
- all delegate arrangements to be governed by an SLA; and
- FMCs to ensure effective engagement with investment managers by challenging the delegate and taking appropriate action when issues arise and be able to provide evidence of such challenge and action.

Risk Management Framework

Issues Identified: The Central Bank identified that many FMCs did not have an entity specific risk management framework, risk register and/or a board approved risk appetite statement in place. In a number of instances this was due to over-reliance on group frameworks.

Expectations: In line with the CP86 requirements, the Central Bank expects all FMCs to have a robust, board approved, entity specific risk management framework in place. This framework should include a risk register and a risk appetite statement. The FMC board should be satisfied that the risk framework is fit for purpose and should ensure that it is reviewed at least annually.

OE Director

Identified Issues: The Central Bank found weaknesses in how the OE Director performs the role in many FMCs. In many cases, the OE Director could not evidence that meetings were conducted and no formal records were kept of meetings with DPs. An absence of formal reporting to the board was also identified, particularly in the area of resource evaluation. Additionally, many OE Directors could not demonstrate that they had given any consideration to conflicts of interest and personal transactions.

Expectations: The Central Bank notes that a key responsibility of the OE Director role is monitoring the adequacy of the FMC's internal resources. Therefore, the Central Bank expects the OE Director to:

- conduct meaningful and regular, (at least quarterly), meetings/interactions with the board and the DPs. These interactions should be formally documented and made available to the Central Bank on request;
- report to the board at least annually and this report should contain information regarding conclusions reached about resourcing and information regarding each of the matters prescribed in CP86;
- ensure that an annual board effectiveness evaluation is conducted and documented; and
- consider conflicts of interest and personal transactions on an ongoing basis.

Board Approval of New Funds

Issues Identified: CP86 requires that the board should seek a report or presentation from the investment manager prior to the issuance of the prospectus and launch of a sub-fund to inform the board of the investment approach that the investment manager proposes to take. The Central Bank identified instances where FMCs could not demonstrate board approval for the launch of sub-funds. In other cases the Central Bank found that the board was approving the fund/strategy just prior to launch and frequently there was no evidence of prior discussions to set or agree the proposed investment strategy prior to submitting the application to the Central Bank.

Expectations: The Central Bank expects:

- evidence of robust discussion and challenge by the board in relation to new fund strategies/structures and their risks; and
- the board to be involved early in the process, for example, when first formulating the investment strategy of a new fund or prior to the submission of the application to the Central Bank.

Additional Findings

The Central Bank also identified a number of governance-related issues that are not specifically included in the current CP86 guidance, including:

- low levels of executive role holders. The Central Bank expects all but the smallest FMCs to have a CEO responsible for the day to day running of the business;
- excessive INED tenures. Instances of INEDs with tenures in excess of 5 and 10 years were identified. The Central Bank expects tenure and ongoing

independence to be included as part of the OE Director's review of board composition and reporting to the board;

- board minutes being insufficiently detailed to capture discussion and challenge; and
- significant gender imbalance on FMC boards.

Actions

All FMCs must carefully review the Findings and critically assess their day to day operational, resourcing and governance arrangements to make necessary changes to ensure the full and effective embedding of all aspects of CP86. FMCs must immediately develop appropriate action plans to meet the Central Bank's expectations. These action plans must be approved by the FMC board by end Q1 2021. FMCs should consider the following minimum requirements when developing these plans:

- the time commitment, skills and expertise of available resources;
- the FMC's retained and delegated tasks, including how ongoing independent challenge of all delegates can be ensured;
- the tasks required by the framework, including those that must be completed on a fund by fund basis;
- how resources and operational capacity will need to increase to take account of any increase in the nature, scale and complexity of the funds under management since authorisation or the last time the FMC critically assessed its operations; and
- how resources and operational capacity will need to increase to deal with a market and/or operational crisis.

FMCs should also continually evaluate their arrangements to ensure they remain fit for purpose.

Next Steps

The Central Bank expects its Findings to be discussed and considered by the board and that individual plans are finalised and approved by the board by the end of Q1 2021. It is likely that FMCs will have time to implement these implementation plans during 2021 as the Central Bank has stated that it will conduct a further industry-wide review in 2022 to assess FMCs' actions on foot of the Findings.

If you would like to discuss the foregoing in more detail, please do not hesitate to contact a member of our team.

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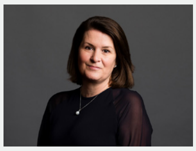

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